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No. 84-1737

In the Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA, PETITIONER

v.

AMERICAN COLLEGE OF PHYSICIANS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether income derived by a tax-exempt medical association from the sale of commercial advertising space in its monthly journal is "unrelated business income" subject to tax under Sections 511 through 513 of the Internal Revenue Code.

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BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-21a) is reported at 743 F.2d 1570. The opinion of the Claims Court (Pet. App. 24a-33a) is reported at 3 Cl. Ct. 531.

JURISDICTION

The judgment of the court of appeals (Pet. App. 22a) was entered on September 17, 1984. A timely petition for rehearing was denied on December 5, 1984 (Pet. App. 23a). On February 26, 1985, the Chief Justice extended the time within which to petition for a writ of certiorari to and including May 4, 1985. The petition was filed on May 3, 1985, and was granted on July 1, 1985 (J.A. 62a). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant portions of Sections 501, 511, 512, and 513 of the Internal Revenue Code of 1954 (26 U.S.C.), and of Sections 1.512 and 1.513 of the Treasury Regulations on Income Tax (26 C.F.R.), are set out in a statutory appendix (Pet. App. 35a-54a).

STATEMENT

1. The basic facts were stipulated below (J.A. 16a-18a). The American College of Physicians is an association exempt from tax under Section 501(c)(3) of the Internal Revenue Code.[1] Its main purposes are to uphold high standards of medical education and practice and to encourage medical research (Pet. App. 24a-25a). Membership in the College is open only to those engaged in practice, teaching, research, or other professional activities in the field of internal medicine (*id.* at 2a). Respondent had approximately 32,000 members in 1975 (J.A. 16a).

In furtherance of its tax-exempt educational purposes, respondent publishes a monthly journal entitled *Annals of Internal Medicine.* The journal is provided to respondent's dues-paying members without charge and is sold to nonmembers on a per-issue basis or by subscription (Pet. App. 25a). Its circulation in 1975 was roughly 73,000 (*id.* at 3a). The journal contains scholarly articles relevant to the practice of internal medicine and is highly regarded in its field (*id.* at 2a).

Each issue of *Annals* also contains commercial advertisements. Up to 40% of the journal's available page space is devoted to advertising on an average yearly basis (J.A. 18a). It is respondent's policy to limit its advertising to those products and services that are useful in the practice of internal medicine (Pet. App. 3a). Some of the advertisements are classified ads, *e.g.*, notices of medical employment opportunities, or offers to buy, sell, or rent medical books, facilities, or equipment (Pet. App. 25a, 58a-59a; J.A. 48a; Br. in Opp. 3-4

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the tax year at issue (the Code or I.R.C.).

& nn. 3 & 4). The bulk of respondent's ads relate to medical products, primarily drugs (Pet. App. 25a). Respondent screens all proffered advertisements as to subject matter and as to the accuracy of their content (*id.* at 3a).

Many of the advertisements appearing in *Annals* are identical with those appearing in medical journals published by taxable commercial publishers, such as the *American Journal of Medicine,* published by a division of Dun & Bradstreet (Pet. App. 28a; J.A. 18a, 43a).[2] Some of the advertisements are eye-catching, others strictly factual; some cover a fraction of a page, others several pages; some are in black and white, many in bright color (Pet. App. 28a). The advertisements are not dispersed throughout the journal, but rather are grouped in discrete "stacks" at the beginning and end of each issue. The same format is generally followed in medical journals published by taxable commercial publishers (*id.* at 3a; J.A. 18a). The advertisements are deleted when the *Annals* are permanently bound.

The advertisements appearing in *Annals* are prepared by the advertisers and not by respondent (Pet. App. 3a). Some of the ads are for established drugs and devices and are repeated from month to month (*id.* at 28a). No effort is made to coordinate the advertising with the journal's editorial content. Thus, it would be coincidental for a drug that is discussed in an article to be featured in an advertisement in the same issue (*id.* at 28a n.3). Advertising space is made available at rates competitive with those charged for advertising space in other medical journals, whether published by taxable or tax-exempt entities (*id.* at 3a; J.A. 18a). According to a

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[2] Selected advertisements appearing in *Annals* and in the *American Journal of Medicine* during January and February 1975 are reproduced at Pet. App. 55a-75a; Br. in Opp. App. B.

policy statement appearing in the July 1977 issue of *Annals*, what "justifies the incorporation of drug advertising in this journal" is the need to obtain "the financial support of drug houses" (J.A. 59a). Thus, it is an important source of revenue to respondent.

2. Sections 511 through 513 of the Code impose a tax on the "unrelated business income" of otherwise tax-exempt organizations like respondent. An "unrelated trade or business" is one the conduct of which "is not substantially related * * * to" (I.R.C. § 513(a)), *i.e.*, does not "contribute importantly to" (Treas. Reg. § 1.513-1(d)(2)), the accomplishment of the organization's tax-exempt purposes. Section 513(c), entitled "Advertising, Etc., Activities," provides that an activity (such as advertising) which bears the earmarks of an unrelated trade or business "does not lose identity as [such] merely because it is carried on within * * * a larger complex of other endeavors" (such as educational endeavors) that further an organization's tax-exempt goals. The Treasury Regulations generally provide that "amounts realized by an exempt organization from the sale of advertising in a periodical constitute gross income from an unrelated trade or business" (Treas. Reg. § 1.512(a)-1(f)).

Respondent's gross advertising revenue from *Annals* in 1975 was $1,376,322 (Pet. App. 3a). After taking into account allowable offsets and deductions, respondent reported "unrelated business taxable income" of $153,388 on its 1975 tax return (*id.* at 4a). Respondent timely filed that return and paid unrelated business income tax of $55,965 for that year (*ibid.*).

On June 12, 1979, respondent filed an administrative claim for refund of the tax thus paid (Pet. App. 4a; J.A. 8a, 10a). When the IRS demurred, respondent, on August 17, 1982, instituted this refund suit in the

Claims Court (Pet. App. 4a; J.A. 11a-12a). Respondent stipulated (J.A. 18a) that its solicitation and publication of commercial advertising was a "trade or business" and that this trade or business was "regularly carried on by it" (I.R.C. § 512(a)(1)). Respondent's principal contention was that its advertising business was "substantially related" to the performance of its educational purposes because "the advertising contains factual and technical data which * * * can help physicians keep up" with recent developments in medicine (Pet. App. 27a-28a).

Following a trial, the Claims Court (Kozinski, C.J.) entered judgment for the United States. The governing legal standards, the court held, were set forth in the Treasury Regulations, which "provide that advertising income of journals like *Annals* generally is taxable" (Pet. App. 29a, citing Treas. Reg. § 1.512(a)-1(f)). The court relied particularly on an Example set forth in the Regulations, an Example the court found "closely [to] resemble[ ] the situation here" (Pet. App. 29a, citing Treas. Reg. § 1.513-1(d)(4)(iv)(Example 7)). That Example, involving a tax-exempt publisher of a professional journal, specifies that "the publication of advertising designed and selected in the manner of ordinary commercial advertising is not an educational activity of the kind contemplated by the exemption statute."

Evaluating the facts under these standards, the court found "unpersuasive" respondent's contention that the advertising in *Annals* "performs an educational function, supplementing the journal's editorial content" (Pet. App. 27a-28a). Respondent's advertising, the court found, "was typical commercial publicity" (*id.* at 28a). Many of the ads appearing in *Annals* were "identical to those appearing in medical journals published by non-exempt organizations," and the court found that any differences in format "plainly reflected the advertiser's

marketing strategy rather than their probable importance to the reader" (*id.* at 28a-29a). Some of the advertising, the court observed, was for well-known and established products like Valium, Insulin, and Maalox, a fact that "undermin[ed] the suggestion that the advertising was principally designed to alert readers of recent developments" (*id.* at 28a & n.4). The court found "[t]he evidence * * * clear that [respondent] did not use the advertising to provide its readers a comprehensive or systematic presentation of any aspect of the goods or services publicized" (*id.* at 28a (footnote omitted)). Rather, "the comprehensiveness and content of the advertising package [was] entirely dependent on each manufacturer's willingness to pay for space and the imagination of its advertising agency" (*id.* at 30a). The court found that respondent's advertising package served no "identifiable educational objective that goes substantially beyond the informational content" necessarily possessed by any advertising, and that any educational function the ads may have served "was incidental to [their] purpose of raising revenue" (*ibid.*). The Claims Court accordingly held that respondent's publication of commercial advertising was not an educational activity, that it did not "contribute importantly to the College's tax-exempt purposes," and that it was therefore subject to unrelated business income tax (*ibid.*).[3]

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[3] The Claims Court also rejected (Pet. App. 30a-33a) respondent's alternative contention that its product advertising was carried on "primarily for the convenience of its members" and was exempt from unrelated business income tax on that basis. See I.R.C. § 513(a)(2). The Federal Circuit upheld the Claims Court's findings in this respect (Pet. App. 19a) and respondent has not sought review of that holding here.

3. The Court of Appeals for the Federal Circuit reversed (Pet. App. 1a-21a). It concluded that the advertising in *Annals* contributes importantly to the accomplishment of respondent's educational purposes by "appris[ing] internists of developments in their field" (*id.* at 19a).

The court turned first to the legislative history accompanying Congress's enactment (in 1969) of Section 513(c), which, as noted above, is entitled "Advertising, Etc., Activities." While acknowledging language in the committee reports indicating that Congress "may have believed that advertising income should be taxed," the court dismissed this legislative history on the ground that it "addresses advertising generally and does not grapple with specific factual situations" (Pet. App. 12a-13a). As the court read the legislative history, Congress did not intend to "adopt a blanket rule" that commercial advertising revenues should be taxed, but rather left to the courts a case-by-case, ad-by-ad determination about whether or not particular advertisements are "substantially related" to an entity's educational objectives (*id.* at 17a-19a & n.23).

The court of appeals agreed with the Claims Court that the "primary purpose" of respondent's advertising was commercial and that its "educational function * * * may well have been secondary to the purpose of raising revenues" (Pet. App. 19a). The court held, however, that "[t]he commercial character of the activity is not * * * determinative" (*id.* at 16a). It concluded that the trial judge had "apparently [been] distracted by the commercial character of the advertisements" and had erroneously evaluated them under "a more rigorous standard than is supported by the statute" (*id.* at 16a, 18a). The court of appeals did not discuss, or even mention, the Treasury Regulation upon which the Claims

Court had based its decision. Rather, relying on testimony of respondent's expert witnesses that the trier of fact had found "unpersuasive" (*id.* at 16a-17a, 28a; J.A. 48a-49a), the court of appeals concluded that "the sales of advertising in *Annals* are substantially related to the exempt purpose of the College to educate internists" and that the Claims Court's conclusion to the contrary was "clearly erroneous" (*id.* at 19a).

The government's petition for rehearing, with suggestion of rehearing en banc, was denied (Pet. App. 23a).

SUMMARY OF ARGUMENT

1. The question in this case is whether respondent's commercial advertising profits are subject to unrelated business income tax. The answer depends on whether the publication of those ads is "substantially related to," that is, "contributes importantly to," the accomplishment of respondent's tax-exempt educational objectives. I.R.C. § 513(a); Treas. Reg. § 1.513-1(d)(2).

The relevant legal standard is set forth in Example 7 to Treas. Reg. § 1.513-1(d)(4)(iv), which was promulgated in 1967. Example 7 concludes that a tax-exempt professional association's publication, in its monthly journal, of advertising "designed and selected in the manner of ordinary commercial advertising is not an educational activity"; that publication of such advertising "does not contribute importantly to the accomplishment of [the organization's] exempt purposes"; and that the income from such advertisements "constitutes gross income from unrelated trade or business." The Regulation makes absolutely clear that "professional interest advertising," for products like drugs and medical devices, and "general consumer advertising," for products like soft drinks and cars, are to be treated identically in this respect. Compare Treas. Reg. § 1.513-1(d)(4)(iv) (Example 6) with *id.* (Example 7).

This Regulation was the subject of extensive hearings before Congress in 1969. The Regulation was attacked by spokesmen for the tax-exempt press, who argued that the Treasury lacked statutory authority to treat the publication of advertising as a "trade or business" distinct from the publication of a magazine generally. Those spokesmen further contended that professional interest advertising, in any event, was "substantially related" to the accomplishment of their educational goals and should be immune from tax on that basis. The Regulation was defended by spokesmen for the non-tax-exempt press, who viewed it as a necessary check upon the perceived inequity and anti-competitive effect of affording a tax subsidy to their competitors in the marketplace for advertising.

In the Tax Reform Act of 1969, Congress resolved the controversy by endorsing the Regulation, which it determined to "place[ ] in the tax laws" (S. Rep 91-552, 91st Cong., 1st Sess. 75 (1969)). Congress enacted Code Section 513(c), entitled "Advertising, Etc., Activities," which makes clear that the publication of advertising does constitute a discrete "trade or business" for purposes of the unrelated business income tax. And Congress concluded that, "by this standard, advertising in a journal published by an exempt organization is not related to the organization's exempt functions, and therefore * * * this income should be taxed" (H.R. Rep. 91-413, 91st Cong., 1st Sess. Pt. 1, at 50 (1969)). Congress noted that the Regulation had "mainly affected the advertising income of publications such as medical journals" and stated that "[y]our committee wants to make clear that such regulations are valid" (*id.* at 44).

A long line of this Court's decisions confirms that interpretive rulings by the Treasury, "if found to 'implement the congressional mandate in some reasonable manner,'

must be upheld." *National Muffler Dealers Ass'n* v. *United States,* 440 U.S. 472, 476 (1979) (quoting *United States* v. *Cartwright,* 411 U.S. 546, 550 (1973)). And here the Regulation not only implements the congressional mandate, but was specifically endorsed by Congress when it enacted the mandate in question.

2. The court of appeals brushed aside this legislative history, asserting that it "addresses advertising generally and does not grapple with specific factual situations" (Pet. App. 13a). The court did not even mention the 1967 Regulation. Instead, it undertook its own subjective evaluation of respondent's advertisements, concluding that they were "educational" because they helped keep doctors professionally up-to-date.

The facts on which the court of appeals relied are irrelevant as a matter of law. Under the Regulation that Congress explicitly approved, the only relevant factual question is whether respondent's advertising is *commercial* publicity, that is, whether it is "designed and selected in the manner of ordinary commercial advertising" (Treas. Reg. § 1.513-1(d)(4)(iv)(Example 7)). The Claims Court found as a fact that it was. The court determined that the advertising in *Annals* "was typical commercial publicity" and that respondent's advertising business "was operated in material respects like the advertising business of any other publication" (Pet. App. 28a, 33a). The court noted that many of respondent's ads "were identical to those appearing in medical journals published by non-exempt organizations" and that any differences in format or content reflected "the advertiser's marketing strategy rather than their probable importance to the reader" (*id.* at 28a-29a). Far from being exceptional, respondent's pharmaceutical product advertising is of the garden-variety commercial

type and is at the core of the problem that Congress and the Treasury took pains to resolve 16 years ago.

The court of appeals has invalidated sub silentio a Treasury Regulation that, having been explicitly endorsed by Congress, the court apparently did not dare invalidate in terms. In permitting respondent to operate its commercial advertising venture tax-free while its business rivals must pay tax, the decision below flouts Congress's design to achieve parity of tax treatment between exempt and non-exempt entities that publish advertisements for profit.

ARGUMENT

INCOME DERIVED BY A TAX-EXEMPT PROFESSIONAL ASSOCIATION FROM THE PUBLICATION OF ORDINARY COMMERCIAL ADVERTISING IS UNRELATED BUSINESS INCOME SUBJECT TO TAX UNDER SECTIONS 511 THROUGH 513 OF THE INTERNAL REVENUE CODE

A. The Treasury Regulations Set Forth A Per Se Rule That The Solicitation And Publication Of Advertising Designed And Selected In The Manner Of Ordinary Commercial Advertising Is Not An Educational Activity

1. The unrelated business income tax has its genesis in the Revenue Act of 1950, ch. 994, 64 Stat. 906 *et seq.* Before that law was enacted, charitable organizations that carried on ordinary trades or businesses were able to escape tax on their profits on the theory that the charitable "destination" of the revenues took precedence over their commercial "source." Thus, a nationwide vendor of macaroni (*C.F. Mueller Co.* v. *Commissioner,* 190 F.2d 120 (3d Cir. 1951)), and a commercial bathing beach facility (*Roche's Beach, Inc.* v. *Commissioner,* 96 F.2d 776 (2d Cir. 1938)), successfully claimed tax-exempt status simply because their business profits went to charity.

In the Revenue Act of 1950, Congress responded to this problem in two ways. First, it enacted the so-called "antifeeder" provision, now codified in Section 502(a) of the Code. Under that Section, organizations "operated for the primary purpose of carrying on a trade or business for profit" cannot claim tax exemption solely on the ground that their profits go to charity. Second, Congress enacted the "unrelated business income tax," now codified in Sections 511 through 513. Section 511(a) imposes a tax, generally at regular corporate rates, "on the unrelated business taxable income" of most tax-exempt groups. Section 512(a) defines an organization's "unrelated business taxable income" as income derived "from any unrelated trade or business * * * regularly carried on by it." Section 513(a) in turn defines an "unrelated trade or business" as "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption."

The chief impetus behind the new tax was Congress's desire to put the business operations of tax-exempt organizations on an equal footing with those of their taxable commercial counterparts. The House Report stated that "[t]he problem at which the tax on unrelated business income is directed * * * is primarily that of unfair competition." H.R. Rep. 2319, 81st Cong., 2d Sess. 36 (1950). The tax falls on business revenues, not on membership dues or investment income, since Congress regarded the latter sources of funds as traditional and proper mainstays for charitable institutions. S. Rep. 2375, 81st Cong., 2d Sess. 30-31 (1950). As amended by Congress in 1950, the Code "does not deny [a tax]

exemption where the organizations are carrying on unrelated active business enterprises, or require that they dispose of such businesses, but merely imposes the same tax on income derived therefrom as is borne by their competitors" (H.R. Rep. 2319, *supra*, at 37).

2. During the years following the enactment of the unrelated business income tax, uncertainty arose as to whether the tax extended to profits derived by tax-exempt organizations from the solicitation and sale of commercial advertising space in their publications. The IRS took preliminary steps toward taxing journal advertising profits in 1955. See Lehrfeld, *The Unfairness Doctrine: Commercial Advertising Profits as Unrelated Business Income*, 23 Tax Law. 349, 351-352 (1970); Webster, *Unrelated Business Income*, 23 Tax Law. 471, 476 (1970). These steps were temporarily suspended two years later, when the Commissioner "ordered a thorough legal and economic study of advertising income." Lehrfeld, *supra*, 23 Tax Law. at 352.

As contemporary commentators noted, there were two technical arguments against applying the unrelated business income tax to journal advertising profits under the law as it stood in 1950. First, it was universally acknowledged that a journal's articles and editorial content furthered the sponsoring organization's tax-exempt goals. Since the commercial advertisments arguably were part and parcel of a unified trade or business ("publishing") with an ultimately educational end, the tax was said to be inapplicable. See, *e.g.*, Weithorn & Liles, *Unrelated Business Income Tax: Changes Affecting Journal Advertising Revenues*, 45 Taxes 791, 798-800 (1967); Webster, *New Proposals Change Definition of Unrelated Business Income*, 23 J. Tax. 42, 43 (1967); Middleditch & Webster, *The New Unrelated Business Income Regs: What They Mean*,

How to Cope With Them, 24 J. Tax. 174, 176 (1968); Moore, *Current Problems of Exempt Organizations*, 24 Tax. L. Rev. 469, 472 (1969).

A second argument was pressed by tax-exempt publishers of trade and professional journals that eschewed general consumer advertising (*e.g.*, ads for margarine or cars) and restricted their advertising to products and services within the area of their members' professional interest. It was said that such advertising itself promoted, *i.e.*, was "related to," the sponsoring organization's educational objectives by helping members stay up-to-date professionally. See, *e.g.*, Webster, *Effect of Business Activities on Exempt Organizations*, 43 Taxes 777, 788 (1965); Middleditch & Webster, *supra*, 24 J. Tax at 175; Comment, *Taxation: Unrelated Business Income Tax (Sections 511-513) and the 1967 Regulations*, 33 Mo. L. Rev. 230, 246 (1968); Weithorn & Liles, *supra*, 45 Taxes at 806-807. Trade and professional journals, of course, held considerable appeal for advertisers of specialized products, who recognized that such publications had "as [their] primary audience a potential market for [such] product[s] greater than some other, random, heterogeneous advertising audience." Lehrfeld, *supra*, 23 Tax Law. at 357. Indeed, "the vast majority" of tax-exempt journals that published advertising at the time were "special-interest business, trade and technical journals." Wall St. J., July 24, 1964, at 1, col. 6. This second argument was thus available to most tax-exempt groups that published advertising for profit.

3. In June 1964, Commissioner Mortimer M. Caplin confirmed that the Treasury, after prolonged study, was drafting regulations concerning "the extent to which an organization, otherwise exempt, is subject to tax on its income from advertising in periodicals and other publications." Weithorn & Liles, *supra*, 45 Taxes

at 791. Rumors to that effect had earlier made the rounds of the tax-exempt press. See, *e.g.*, Rogovin, *Tax Exemption: Current Thinking Within the Service*, 22 N.Y.U. Inst. Fed. Tax. 945, 961 & n.29 (1964); Webster, *supra*, 43 Taxes at 786-787; Weithorn & Liles, *supra*, 45 Taxes at 791. The anticipated Regulation was issued in proposed form in April 1967. Prop. Reg. § 1.513-1, 32 Fed. Reg. 5993. It was accompanied by a Technical Information Release explaining that it was designed "to make it clear that the unrelated business income tax applies to profits which exempt organizations derive from the sale of advertising in periodicals which they publish." TIR-899 (Apr. 14, 1967), *reprinted in* 1967 Fed. Taxes (P-H) ¶ 54,862.

The Proposed Regulation addressed, and rejected, both of the technical arguments outlined above against taxation of professional journal advertising profits. The Treasury announced its intention to "fragment" tax-exempt publications into two components—commercial advertising, the income from which would be subject to unrelated business income tax, and articles and editorial content, the income from which (typically, subscription or dues income) would remain tax-free. Articulating the "fragmentation" concept, the Proposed Regulation set forth the general rule that income-producing activities "do not lose identity as [a] trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization." Prop. Reg. § 1.513-1(b), 32 Fed. Reg. 5993 (1967). "Thus," the Treasury explained, "activities of soliciting, selling, and publishing commercial advertising do not lose identity as [a] trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to [its] exempt purposes" (*ibid.*).

To illustrate this principle, the Proposed Regulation set forth an Example involving a tax-exempt trade group ("Z") that publishes a monthly journal containing articles and commercial advertising. Prop. Reg. § 1.513-1(d)(4)(iv)(Example 6), 32 Fed. Reg. 5995 (1967). The Example concluded that the journal's editorial content "contribute[s] importantly to the accomplishment" of the organization's tax-exempt purposes, and hence that its subscription income "does not constitute gross income from unrelated trade or business" (*ibid.*). On the other hand, the Example held that "[n]either the publication of advertisments nor the performance of services for commercial advertisers contributes importantly to the accomplishment of any purpose for which exemption is granted," so that the journal's advertising profits were subject to tax.

4. The Proposed Regulation provoked written comments from some 400 organizations, many of which testified at hearings held by the Treasury in July 1967. Taxpaying publishers praised the proposal as a means of restricting the competitive edge enjoyed by their tax-exempt counterparts. The tax-exempt press, on the other hand, attacked the Proposed Regulation as contrary to congressional intent and to prior IRS practice. Many faulted the Treasury's proposal, not only for adopting the "fragmentation" concept, but also for creating, with insufficient explanation, "a *per se* rule as to advertising from commercial sources." Lehrfeld, *supra*, 23 Tax Law. at 350.

In response to the comments received, the Treasury revised Example 6 of the Proposed Regulation, and inserted a new Example 7, to elaborate and clarify the basis for its conclusion that *all* commercial advertising profits are subject to unrelated business income tax. As thus revised, the Regulation carried forward the substance of the Treasury's original proposal. The

Regulation was published in final form in December 1967 (Treas. Reg. § 1.513-1, 32 Fed. Reg. 17657). It has remained essentially unchanged ever since.

Examples 6 and 7 of the Final Regulation each involve a trade association (again named "Z") formed "to advance the interests of a particular profession and drawing its membership from the members of that profession" (32 Fed. Reg. 17659 (1967)). The association publishes a monthly journal that carries articles and commercial advertising. In Example 6, Z publishes "general consumer advertising" for products like "soft drinks, automobiles, articles of apparel, and home appliances." The Example concludes that such advertising revenues represent "gross income from [an] unrelated trade or business" (*ibid.*). In Example 7, the facts are the same as in Example 6, "except that the advertising in Z's journal promotes only products which are within the general area of professional interest of its members." Example 7 elaborates the hypothetical facts as follows:

> Following a practice common among taxable magazines which publish advertising, Z requires its advertising to comply with certain general standards of taste, fairness, and accuracy; but within those limits the form, content, and manner of presentation of the advertising messages are governed by the basic objective of the advertisers to promote the sale of the advertised products. While the advertisements contain certain information, the informational function of the advertising is incidental to the controlling aim of stimulating demand for the advertised products and differs in no essential respect from the informational function of any commercial advertising. Like taxable publishers of advertising, Z accepts advertising only from those who are willing to pay its prescribed rates.

The Example acknowledges that "continuing education of its members in matters pertaining to their profession is one of the purposes for which Z is granted exemption." It concludes, however, that "the publication of advertising designed and selected in the manner of ordinary commercial advertising is not an educational activity of the kind contemplated by the exemption statute" (32 Fed. Reg. 17659 (1967)). Thus, "Z's publication of advertising does not contribute importantly to the accomplishment of its exempt purposes; and the income which it derives from advertising constitutes gross income from unrelated trade or business" (*ibid.*).

B. In Amending The Tax Laws In 1969, Congress Explicitly Approved The Regulation In Question And Announced That, Under The Statutory Standard It Was Then Adopting, All Commercial Advertising Profits Of Tax-Exempt Professional Journals Are Subject To Unrelated Business Income Tax

1. The Final Regulation triggered a renewed storm of protest from tax-exempt publishers. Estimates before Congress indicated that the Regulation would affect "[s]ome 700 fraternal, educational, cultural, scientific, professional, trade, and labor organizations" with gross advertising revenues of about $100 million. See 114 Cong. Rec. 7879 (1968). During 1968, members of the House sympathetic to their interests introduced numerous bills to block the Regulation's implementation. See Lehrfeld, *supra*, 23 Tax Law. at 364-365; Weithorn & Liles, *supra*, 45 Taxes at 792 n.8. These initiatives were unsuccessful.

Several attempts along similar lines were made in the Senate. In March 1968, the Senate approved a measure, initiated on the floor, that would have amended Section 513(a) of the Code to specify that the publication of commercial advertising in an exempt-organization periodical is not an unrelated trade or business. 114 Cong. Rec. 7879-7881 (1968). The amendment was deleted in conference, on the understanding that the House Ways

and Means Committee would consider the subject later that year. See S. Rep. 1497, 90th Cong., 2d Sess. 11 (1968). In September 1968, the Senate Finance Committee reported out an amendment to a water conservation bill that would have postponed for one year the Regulation's effective date. See 114 Cong. Rec. 27617, 27619 (1968). According to the accompanying Report, the Committee thought such a deferral appropriate "[i]n view of the substantial impact of the new regulations and the widespread concern which has been expressed regarding them" (S. Rep. 1497, *supra*, at 11). The proposal to defer the Regulation's effective date was defeated on the floor. 114 Cong. Rec. 27785-27788 (1968). Senator Anderson, who led the opposition to the proposal, observed that it would "open[ ] up a loophole that could cost the general taxpayers $25,000,000 a year" (*id.* at 27785). Senator Metcalf agreed, stating that "it is difficult to see why th[e] tax exemption should be spread beyond its necessary limits to give a tax-exempt organization an unwarranted and unnecessary competitive advantage over its taxable business competitors" (*id.* at 27787).

2. The promised hearings were held the following year, and the Regulation was subjected to several days of scrutiny by spokesmen for both the tax-exempt and the non-exempt press. See *Tax Reform, 1969: Hearings Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess. (1969) [hereinafter cited as *House Hearings*]; *Tax Reform Act of 1969: Hearings on H.R. 13270 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess. (1969) [hereinafter cited as *Senate Hearings*]. Publishers of medical journals were well represented. See, *e.g.*, *House Hearings* 1259 (American Medical Ass'n); *id.* at 1211 (American Dental Ass'n); *id.* at 1117 (American Psychiatric Ass'n); *id.* at 1110 (American College of Physicians, respondent here); *id.* at 1150

(Reuben H. Donnelley Corp.); *id.* at 1205 (C.V. Mosby Co.). Witnesses on both sides iterated before Congress the arguments they had previously advanced to the Treasury.

Tax-exempt publishers opposed the Regulation on two principal grounds. First, they contended that the Treasury lacked statutory authority to "fragment" publishing activity and to treat commercial advertising as a "trade or business" distinct from the publication of a journal generally. See, *e.g.*, *House Hearings* 1111, 1128-1129, 1184, 1213, 1223. That contention, if accepted, would have shielded virtually all advertising revenues from tax.

Secondly, tax-exempt publishers challenged the Regulation for establishing a "presumption" or "*per se* rule" that all commercial advertising, regardless of its nature, is necessarily unrelated to the publishing organization's tax-exempt goals.[4] These groups contended that ads for products and services within their

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[4] See, *e.g.*, *House Hearings* 928 (American Radio Relay League) (Regulation "indicate[s] that advertising is unrelated per se to an exempt purpose"); *id.* at 1113 (American College of Physicians) ("The new Treasury regulations have the effect of conclusively presuming that advertising income derived from the [C]ollege's publication constitutes taxable * * * income."); *id.* at 1118 (American Psychiatric Association) (Regulation "presumes that any advertising in trade and professional journals is 'unrelated' to the purposes of the organization"); *id.* at 1192 (American Ceramic Society) (Regulation effects "blanket taxation of all advertising"); *id.* at 1241 (Institute of Electrical and Electronics Engineers) ("The regulations take the position that all advertising income is subject to tax, regardless of its nature."); *Senate Hearings* 1670 (National Association of Life Underwriters) ("the Service ruled * * * that all advertising is to be considered unrelated, ergo, that no advertising can in any way be related to any tax exempt purpose of any exempt organization").

members' area of specialized interest— *e.g.*, laboratory and clinical equipment for public health professionals (*House Hearings* 1404), whirlpool tubs and traction apparatus for physical therapists (*id.* at 1402), and textbooks for teachers (*id.* at 1410, 1412, 1422)— as distinguished from general consumer advertising, "contributed importantly" to their tax-exempt purposes by enhancing their members' professional competence. As one witness explained, "[i]n most scientific journals published by professional associations, advertisements are limited to products and services that are essential to the proper and efficient practice of the profession involved" (*House Hearings* 1213). This "relatedness" theory was embraced by trade and professional groups across the board, some exempt as educational and charitable organizations under Section 501(c)(3), others exempt as business leagues under Section 501(c)(6).[5]

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[5] *E.g.*, *House Hearings* 928 (American Radio Relay League) ("It has long been the policy of the league to accept only advertising of products pertinent to the field of amateur radio communications, products which assist the amateur in his self-training and development of techniques."); *id.* at 1241 (Institute of Electrical and Electronics Engineers) ("IEEE should not be subject to tax on income derived from advertisements of products embodying the latest scientific developments."); *id.* at 1380 (American Association of Petroleum Geologists) ("The advertisers in the BULLETIN are carefully screened and only those advertisements which will update members' knowledge of materials and services related to petroleum geology are selected for inclusion."); *id.* at 1405 (American Society for Information Science) ("the advertising messages are, in effect, an extension of the editorial function itself, in that they inform persons in the information science field of recent innovations, current literature, and professional services offered"); *id.* at 1412 (Association for Childhood Education International) ("advertising of educational books and materials in *Childhood Education* is a vital part of its function of keeping its

Among the chief proponents of this "relatedness" theory were tax-exempt publishers of medical journals. They maintained that ads for drugs and other therapeutic agents furthered their educational goals by helping doctors keep abreast of recent developments. As a spokesman for the AMA put it, "[d]rug advertisements often provide an important step in the process through which the physician becomes educated in the therapeutic value and risks of new drugs" (*House Hearings* 1261). Tax-exempt medical publishers emphasized that such advertising provided reliable information, not only because it was regulated by the FDA, but also because it was screened by the organizations themselves. They maintained that they consistently refused to print any advertisement that did not have a direct bearing on their readers' professional practice.[6]

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members informed of new developments in education"); *Senate Hearings* 1670 (National Association of Life Underwriters) ("the magazine will accept only advertising which describes a service or a product that is of value to the life insurance agent in his capacity as an agent").

[6] See, *e.g.*, *House Hearings* 1111-1112 (American College of Physicians) ("The advertising carried in the *Annals of Internal Medicine* complements the other educational activities of the [C]ollege."); *id.* at 1119 (American Psychiatric Ass'n) (psychiatrists and other physicians "learn in this way about new drugs, indications, and contraindications for their use, and other information of practical value"); *id.* at 1213-1214 (American Dental Ass'n) ("The advertising program in the association's publications * * * is an important service to the practicing dentist."); *id.* at 1260-1261 (American Medical Ass'n) ("Drug advertising alerts and stimulates the physician's interest in new drugs as they become available"); *id.* at 1391 (American Hospital Ass'n) (advertising is "an effective means of keeping this special audience well informed and up to date within their special province"). See also *id.* at 1197 (American College of Obstetricians and Gynecologists); *id.* at 1375 (American Academy of General Practice); *id.* at 1418 (Louisiana Dental Ass'n).

Taxpaying publishers of trade and professional journals, on the other hand, defended the Regulation as a check upon the perceived inequity and anti-competitive effect of affording a subsidy to their tax-exempt counterparts. See, *e.g.*, *House Hearings* 1109 (Nat'l Newspaper Ass'n); *id.* at 1116 (Second-Class Mail Publications); *id.* at 1140 (Associated Construction Publications); *id.* at 1150 (McGraw-Hill Publications); *id.* at 1246 (Fairchild Publications). They maintained that their periodicals, no less than those of their tax-exempt competitors, help keep readers professionally up-to-date. They emphasized that all publishers, whatever their tax status, vie for advertising dollars using the same sales techniques. They noted that taxpaying and tax-exempt publishers regularly run identical ads—indeed, a pair of competing chemical journals had once run 115 identical ads within a space of six months. See *House Hearings* 1145-1151, 1208; *Senate Hearings* 1111-1112. And they urged that if Congress were to carve out any exception for so-called "related" ads, the exception would eventually swallow the Regulation's rule that commercial advertising is subject to tax. As one witness put it, "[t]his would be a wide open, tax-escaping door, and every advertisement would somehow be related" (*House Hearings* 1150).

A number of witnesses spoke on behalf of taxpaying medical journals in particular. They pointed out that they likewise "screened" their ads for accuracy and relevance to the practice of medicine. And they contended that the tax-free status accorded many of their competitors had the effect of artificially depressing the advertising rates they could charge. *House Hearings* 1150-1152, 1176, 1177-1178, 1205-1210. One witness estimated that drug houses and medical equipment manufacturers in 1968 had spent more than $100 million to promote their products, up to $30 million of which went to tax-exempt publishers. *House Hearings* 1205-1206.

The evidence before Congress showed that the *Journal of the American Medical Association* (which is published by a tax-exempt organization) alone accounted for $10.5 million of that total—the largest advertising revenue of any trade or professional journal in the country (*Senate Hearings* 1088). Indeed, contemporary newspaper accounts noted that the AMA's journal in 1963 "carried 5,262 pages of ads, more than any other national weekly magazine except the New Yorker and the Oil & Gas Journal." Wall St. J., July 24, 1964, at 1, col. 6.

3. In the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 *et seq.*, Congress resolved the controversy by endorsing the Regulation and paving the way for its enforcement. Congress added to the Code new Section 513(c), entitled "Advertising, Etc., Activities." It provides that the term "trade or business" includes any activity "carried on for the production of income," and that "an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization." Those words, expressly sanctioning "fragmentation" of an activity into exempt-purpose and unrelated-business components, were taken almost verbatim from the 1967 Treasury Regulation promulgated to deal with the commercial advertising problem. Compare I.R.C. § 513(c) with Treas. Reg. § 1.513-1(b), 32 Fed. Reg. 17657 (1967).

The legislative history accompanying Section 513(c) plainly shows that Congress intended to codify the treatment of advertising income prescribed by the 1967 Regulation. The Treasury Department took the position

before Congress that the bill "codifies previously existing Treasury Regulations defining activities such as advertising, which will be treated as unrelated business." *Senate Hearings* 568 (testimony of Assistant Secretary for Tax Policy Edwin S. Cohen). Accord, Staff of Senate Comm. on Finance, 91st Cong., 1st Sess., *Tax Reform Act of 1969, H.R. 13270: Technical Memorandum of Treasury Position* 34 (Comm. Print 1969). The House Report recited that the Regulation "mainly affected the advertising income of publications such as medical journals" and stated that "[y]our committee wants to make clear that such regulations are valid." H.R. Rep. 91-413, 91st Cong., 1st Sess. Pt. 1, at 44 (1969). The Report then explains the new Section 513(c) as follows (*id.* at 50):

> Because of the ensuing controversy over this problem your committee has decided to deal with the subject by legislation. In general, it is in agreement with the purpose of the regulations. Your committee believes that a business competing with taxpaying organizations should not be granted an unfair competitive advantage by operating tax free unless the business contributes importantly to the exempt function. It has concluded that by this standard, advertising in a journal published by an exempt organization is not related to the organization's exempt functions, and therefore it believes that this income should be taxed.

The Senate Report is equally explicit. It notes the controversy over the 1967 Regulation and continues as follows (S. Rep. 91-552, 91st Cong., 1st Sess. 75 (1969)):

> The committee agrees with the House that the regulations reached an appropriate result in specifying that when an exempt organization carries on an advertising business in competition with other taxpaying advertising businesses, it should pay a tax on

> the advertising income. The statutory language on which the regulations are based, however, is sufficiently unclear so that substantial litigation could result from these regulations. For this reason, the committee agrees with the House that the regulations, insofar as they apply to advertising and related activities, should be placed in the tax laws.

The Report goes on to summarize the language of new Section 513(c), and concludes: "Under this provision, advertising income from publications (whether or not the publications are related to the exempt purpose of the organization) is to constitute unrelated business income to the extent it exceeds the expenses related to the advertising" (S. Rep. 91-552, *supra*, at 75-76). The Treasury was directed to "prescribe regulations indicating the appropriate methods for allocating income and expenses" as between taxable product advertising and tax-exempt editorial content (*id.* at 76).[7]

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[7] The regulations issued pursuant to this directive provide generally that "[u]nder section 513 * * * and § 1.513-1, amounts realized by an exempt organization from the sale of advertising in a periodical constitute gross income from an unrelated trade or business." Treas. Reg. § 1.512(a)-1(f)(1). They then set forth detailed allocation rules for advertising income and expenses. Treas. Reg. § 1.512(a)-1(f)(2) through (7).

As both the Senate Report and the commentators had predicted, the 1967 Regulation did generate "substantial litigation" (S. Rep. 91-552, *supra*, at 75) concerning its application to tax years antedating Congress's enactment of Section 513(c). Indeed, two courts declared the Regulation invalid as applied to pre-1970 tax years, reasoning that the Treasury previously lacked statutory authority to "fragment" publishing activity into taxable and tax-exempt components. See *Massachusetts Medical Soc'y* v. *United States*, 514 F.2d 153, 154 (1st Cir. 1975); *American College of Physicians* v. *United States*, 530 F.2d 930, 933 (Ct. Cl. 1976). In so holding, the Court of Claims recognized that Congress in 1969

C. In Holding Respondent's Advertising Profits Immune From Unrelated Business Income Tax, The Court Of Appeals Ignored The Legislative History, The Governing Regulation, And The Trial Court's Findings of Fact

Surveying this legislative history, the Federal Circuit concluded that Congress in 1969 had laid down no "blanket rule" (Pet. App. 12a) about commercial advertising in tax-exempt professional journals. The court did not even address the effect of the applicable Treasury Regulation, which Congress had explicitly endorsed. Instead, the Federal Circuit believed that Congress had left the door ajar and consigned to the IRS and the courts a case-by-case, ad-by-ad determination as to whether *some* advertisements in *some* journals are "substantially related" to the publisher's educational purposes (see Pet. App. 13a, 19a & n.23). In overturning the Claims Court's findings, moreover, the court of appeals implied that respondent's advertising is distinguishable in some relevant respect from the common run of advertising with which Congress was obviously concerned. The court erred in each step of its analysis.

1. To begin with, Congress in 1969 quite plainly did adopt a "blanket rule" that commercial advertising profits of professional journals are subject to unrelated business income tax. The 1967 Treasury Regulation, which Congress explicitly approved and determined to "place[ ] in the tax laws" (S. Rep. 91-552, *supra*, at 75), was uniformly interpreted, both by the leading commen-

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"prospectively amended [Section 513] to validate the 1967 regulations," and it accordingly limited its decision to tax years before the effective date of that enactment (530 F.2d at 930-931 n.2). The taxpayer in the First Circuit case—like respondent, a tax-exempt publisher of a medical journal—"acknowledge[d] that its advertising activities [came] within the new regulations' definition of an unrelated trade or business" (514 F.2d at 154).

tators at the time [8] and by witnesses who tried to persuade Congress not to endorse it,[9] as creating a presumption or blanket rule to that effect. After all, the Regulation unequivocally states that "the publication of advertising designed and selected in the manner of ordinary commercial advertising is not an educational activity of the kind contemplated by the exemption statute." Treas. Reg. § 1.513-1(d)(4)(iv)(Example 7). And Congress made clear that, under the statutory standard it was adopting, "advertising in a journal published by an exempt organization is not related to the organization's exempt functions, and therefore * * * this income should be taxed" (H.R. Rep. 91-413, *supra*, at 50). Although the blanket rule that Congress enacted may admit of exceptions,[10] Congress

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[8] See, *e.g.*, Lehrfeld, *supra*, at 355 (" *per se* rule"); Weithorn & Liles, *supra*, 45 Taxes at 806 ("*all* journal advertising constitutes unrelated business") (emphasis in original); Middleditch & Webster, *supra*, at 175 ("Under the new Regulations, all advertising in an organization publication is now taxable"); Webster, *supra*, 23 Tax Law. at 476 (effect of Section 513(c) is "[t]o tax all commercial advertising income"); Sugarman & Vogt, *The New Advertising Regulations and Their Application to Exempt Organizations*, 54 Taxes 196 (1976) ("By statute gross advertising income from a periodical of an otherwise tax-exempt organization is subject to * * * tax.").

[9] See, *e.g.*, *House Hearings* 928 (Regulation "indicate[s] that advertising is unrelated per se"); *id.* at 1113 (Regulation "conclusively presum[es]" that advertising is unrelated); *id.* at 1118 (Regulation "simply presumes" that advertising is unrelated); *id.* at 1192 (Regulation effects "blanket taxation of all advertising"); *id.* at 1241 (Regulation takes position "that all advertising income is subject to tax, regardless of its nature"); *Senate Hearings* 1670 (Regulation means "that no advertising can in any way be related"); *id.* at 1716 (Regulation "presumes" that advertising is unrelated).

[10] The chief exception recognized by the Treasury Department, an exception that was before Congress in 1969, concerns advertising published in a student-run campus newspaper, where "solicitation, sale, and publication of the advertising are conducted by students, under the supervision and instruction of the university."

plainly intended that the exceptions would be rare indeed.[11]

There is, moreover, no suggestion anywhere in Section 513(c) or its legislative history that Congress intended the courts to confer ad hoc immunity from the unrelated business income tax depending on their subjective, case-by-case evaluation of how "educational" particular advertisements seem to be. The Regulations do provide, in general, that whether an activity is "substantially related" to an exempt purpose "depends in each case upon the facts and circumstances involved" (Treas. Reg. § 1.513-1(d)(2)). However, Congress and the Treasury Department have definitively undertaken this calculus with respect to professional journal advertising activities in particular, and have determined, as a matter of law, that commercial advertising published in the journal of a tax-exempt professional organization "is not related to the organization's exempt functions, and therefore * * * this income should be taxed" (H.R. Rep. 91-413, *supra*, at 50). There is simply no room for courts to second-guess that determination and thereby defeat the very uniformity and even-handedness of tax treatment that Congress sought to achieve.

Treas. Reg. § 1.513-1(d)(4)(iv)(Example 5). The Example concludes that, under these circumstances, publication of the advertising contributes importantly to the university's educational goals "by means of student instruction of other students in the * * * advertising activities and student participation in those activities." See also Rev. Rul. 76-93, 1976-1 C.B. 170 (recognizing exception for advertisement which contains no commercial message but merely lists a company's name, along with the names of 59 other corporate "patrons," on a single page).

[11] As one commentator put it (rather ironically, as it turns out): "[I]t is arguable [after the enactment of Section 513(c)] that there can still be 'related' advertising. However, the legislative history and intent of the Congress is so clear that the likelihood of this argument prevailing as to any period after December 31, 1969 is very improbable." Webster, *supra*, 23 Tax Law. at 476.

2. In light of the legislative history, the only relevant "factual" question is that posed by the Regulation itself—whether respondent's advertising was *commercial* publicity, *i.e.*, whether it was "designed and selected in the manner of ordinary commercial advertising." Treas. Reg. § 1.513-1(d)(4)(iv)(Example 7). The Claims Court found as a fact that it was. "Example 7," the court noted, "closely resembles the situation here" (Pet. App. 29a). Respondent's advertising "was typical commercial publicity" (*id.* at 28a). Many of the products advertised—products like Valium, Tylenol, Darvon, Robitussin, Maalox, insulin, aspirin, and support socks—were for established products and were repeated from month to month, following the standard commercial practice (*id.* at 28a & n.4, 56a-57a, 62a-63a; J.A. 29a-30a). The design of the ads—the use of "eye-catching" formats, the fact that many were in "bright color" and "covered * * * several pages"—was indistinguishable from that of commercial advertisements generally (Pet. App. 28a). "[M]any [of respondent's] ads were identical to those appearing in medical journals published by non-exempt organizations," any differences in content or format reflecting "the advertiser's marketing strategy rather than their probable importance to the reader" (*id.* at 28a-29a). The layout of respondent's ads—being grouped in "stacks" at the beginning and end of the magazine—again corresponded to standard commercial practice (Pet. App. 29a; J.A. 18a). Respondent's "advertising business * * * was operated in material respects like the advertising business of any other publication"—"[t]hose companies willing to pay for advertising space got it; others did not" (*id.* at 28a, 33a). Respondent's rates were "competitive with those of other medical journals" (*id.* at 25a) and "any educational function [respondent's advertising] may have served was incidental to its purpose of raising revenue" (*id.* at 30a). These factual findings

amply justified the Claims Court's conclusion that respondent's ads were " 'designed and selected in the manner of ordinary commercial advertising,' " a conclusion which, under the governing Regulation, means that respondent's advertising " 'is not an educational activity of the kind contemplated by the exemption statute' " (Pet. App. 29a, quoting Treas. Reg. § 1.513-1(d)(4)(iv) (Example 7)).

The court of appeals did not disagree with any of these basic findings of fact. Indeed, it could scarcely have done so, since most of the facts were stipulated. Rather, without mentioning the Regulation, it rejected the legal standard the Regulation prescribes, holding that the Claims Court had erred in focusing "on the commercial character of the advertising and on the degree of similarity to advertising activity carried on by commercial organizations" (Pet. App. 14a). The court of appeals then proceeded to conduct its own subjective evaluation of whether the ads were "educational." In holding that they were, it relied chiefly on the facts that the ads were "screened with respect to subject matter and * * * accuracy," were restricted to "products and services related to the practice of internal medicine," and served "to inform the physician of recent developments by disseminating information concerning those developments"—an informational function which the court conceded "may well have been secondary to the purpose of raising revenues" (*id.* at 17a, 19a).

The facts on which the court of appeals relied are irrelevant as a matter of law. The advertisements described in Example 7 are also screened, "[f]ollowing a practice common among taxable magazines which publish advertising," to ensure that they "comply with certain general standards of taste, fairness, and accuracy" (Treas. Reg. § 1.513-1(d)(4)(iv)). The advertisements described in Example 7 also "promote only products which are within the general area of profes-

sional interest of [the assocation's] members" (*ibid.*). And the advertisements described in Example 7 also "contain certain information," an informational function which is "incidental to the controlling aim of stimulating demand for the advertised products" (*ibid.*). Notwithstanding these facts, Example 7 concludes that the advertising, because of its *commercial* character, "is not an educational activity" (*ibid.*). Indeed, the Treasury Department went out of its way, by amending the Proposed Regulation after receiving comments from the tax-exempt press, to make clear that "professional interest advertising," for products like drugs and medical devices, and "general consumer advertising," for products like soft drinks and cars, are to be treated identically for purposes of the unrelated business income tax. Compare Prop. Reg. § 1.513-1(d)(4)(iv)(Example 6), 32 Fed. Reg. 5995 (1967), with Treas. Reg. § 1.513-1 (d)(4)(iv)(Examples 6 and 7), 32 Fed. Reg. 17659 (1967).

The facts upon which the court of appeals relied are also precisely the same facts that spokesmen for the tax-exempt press repeatedly emphasized before Congress in 1969 in an unsuccessful effort to have the Regulation legislatively overruled. See pages 20-22 & notes 5-6, *supra*. Pharmaceutical product advertising was at the core of the problem Congress addressed. Witness after witness testified, just as respondent's witnesses testified below, that ads in medical journals are "educational" because they perform a valuable "alerting function," provide information about "new drugs, indications, and contraindications for use," and keep doctors "well informed and up to date." Compare, *e.g.*, *House Hearings* 1119, 1260-1261 & 1391 with J.A. 27a-28a, 37a, 40a, 43a. Congress was unpersuaded by their testimony. It expressly approved the Regulation, noting that it "mainly affected the advertising income of

publications such as medical journals" (H.R. Rep. 91-413, *supra*, at 44), and determined that the regulations, "insofar as they apply to advertising and related activities, should be placed in the tax laws" (S. Rep. 91-552, *supra*, at 75). A long line of this Court's decisions confirms that interpretive rulings by the Treasury, "if found to 'implement the congressional mandate in some reasonable manner,' must be upheld." *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472, 476 (1979) (quoting *United States* v. *Cartwright*, 411 U.S. 546, 550 (1973)). And here the Regulation not only implements the congressional mandate, but was specifically endorsed by Congress when it enacted the mandate in question. See *Red Lion Broadcasting Co.* v. *FCC*, 395 U.S. 367, 381-382 (1969).

D. There Is No Merit To Respondent's Argument That The Principles Of Example 7 Of The Regulation Apply Only To Publishers Exempt Under Section 501(c)(6), To The Exclusion Of Publishers Exempt Under Other Subsections of Section 501(c)

Respondent appears to have recognized early in this litigation that its advertising is indistinguishable from that described in Example 7 of the Regulations, and hence that it could not prevail if the principles of that Example were he' dispositive. In its complaint, respondent alleged that the Regulation was invalid. J.A. 8a. That argument, however, would have required proof that the Regulation was inconsistent with the statute—an awkward undertaking, since Congress had expressly approved the Regulation in 1969. Respondent shifted gears in its pretrial brief and contended that the Claims Court need not consider the validity of Example 7, on the theory that the principles of that Example apply only to tax-exempt publishers organized as trade associations under Section 501(c)(6), and not to tax-exempt publishers (like respondent) organized as educational associations under Section 501(c)(3). Cl. Ct.

Br. 22-25. The Claims Court, while not explicitly addressing this argument, rejected it by implication. See Pet. App. 29a. Respondent raised the argument again on appeal (C.A. Br. 30-31), but the Federal Circuit neither mentioned it nor relied on it as a basis of decision.

Respondent reiterates its contention here (Br. in Opp. 11-13). It notes that the hypothetical organization described in Example 6 of the Proposed Regulation was an "exempt trade association" (32 Fed. Reg. 5995 (1967)), and that the hypothetical organization described in Examples 6 and 7 of the Final Regulation is "an association exempt under section 501(c)(6), formed to advance the interests of a particular profession" (32 Fed. Reg. 17659 (1967)). Respondent disclaims any challenge to the validity of these Examples (Br. in Opp. 12), conceding that "the IRS may plausibly contend that Example 7 is a shorthand determination that advertising will not have a 'substantial relationship' to an exempt purpose for a [Section 501](c)(6) organization" (*ibid.*). Respondent contends, however, that "[t]he same cannot be said" of charitable or educational organizations exempt under Section 501(c)(3)—or, presumably, of organizations exempt under the twenty-odd other subsections of Section 501(c). In respondent's view, the Treasury's choice of a trade association for use in these two Examples was not accidental or merely illustrative, but reflected a deliberate decision to confine the legal analysis that the Examples set forth to publishers who rely on Section 501(c)(6) as the basis for their tax exemption. This argument is altogether meritless.

1. Section 501(c)(6) provides an exemption inter alia for "[b]usiness leagues" and "boards of trade." In order to qualify for exemption under that subsection, an organization's activities must be "directed to the improvement of business conditions of one or more lines of

business." Treas. Reg. § 1.501(c)(6)-1. See *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472 (1979). Providing educational services to members on subjects germane to their professional interests is among the purposes that may qualify an association for exemption as a "business league." *E.g.*, *National Leather & Shoe Finders Ass'n* v. *Commissioner*, 9 T.C. 121 (1947). See generally *Louisiana Credit Union League* v. *United States*, 693 F. 2d 525, 535-536 (5th Cir. 1982). Thus, the trade association described in Example 7 is said to have "continuing education of its members in matters pertaining to their profession" as one of its exempt purposes, and the publication of articles in its monthly journal is said to "contribute importantly to the accomplishment" of those educational objectives. Treas. Reg. § 1.513-1(d)(4)(iv)(Example 7).

A professional association like respondent, whose members are drawn from a single profession and which has broad educational or charitable goals, generally has the option of qualifying for tax exemption *either* as an educational association under Section 501(c)(3) *or* as a business league under Section 501(c)(6). The chief differences are pragmatic. Section 501(c)(3) groups may receive donations that are deductible by individual donors as charitable contributions, whereas business leagues may not. See I.R.C. § 170(c)(2). Section 501(c)(3) groups, on the other hand, may not engage in political campaign activity or in substantial lobbying without forfeiting their tax exemption, while business leagues do not operate under those constraints. Compare I.R.C. § 501(c)(3) with I.R.C. § 501(c)(6).[12] Thus, the form of

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[12] The relationship between Sections 501(c)(3) and 501(c)(6) as possible bases of classification for tax-exemption purposes has long been troublesome. See generally *Better Business Bureau* v. *United States*, 326 U.S. 279 (1945).

tax exemption chosen by a professional association like respondent will typically depend on funding considerations and on the intended scope of its activites. Respondent and the American Psychiatric Association, for example, both of which publish scholarly medical journals for their members, are exempt under Section 501(c)(3). The American Medical Association and the American Dental Association, which likewise publish scholarly medical journals for their members, are exempt under Section 501(c)(6).

2. Respondent's attempt to posit a dichotomy in the treatment of advertising income, depending on whether the publishing organization is exempt under Section 501(c)(3) or Section 501(c)(6), is utterly unprecedented. In the long, detailed history of this issue, we know of no instance in which the IRS, the Congress, a court, or a commentator has suggested that the principles of Example 7 are confined to advertising published by Section 501(c)(6) organizations, to the exclusion of advertising published by other tax-exempt groups. In announcing the Proposed Regulation, the IRS said that it was designed "to make it clear that the unrelated business income tax applies to profits which *exempt organizations* derive from the sale of advertising in periodicals which they publish" (TIR-899, *supra* (emphasis added)). Commentators discussing the Proposed Regulation uniformly characterized it as creating a "*per se* rule" (Lehrfeld, *supra*, 23 Tax Law. at 355) that "*all* journal advertising constitutes unrelated business" (Weithorn & Liles, *supra*, 45 Taxes at 806 (emphasis original)). Leaders of the unsuccessful campaign to block the Regulation on the floor of Congress in 1968 described it as imposing a tax on the advertising profits of "fraternal" organizations (exempt under Section 501(c)(8)),

"educational" organizations (exempt under Section 501(c)(3)), "trade" organizations (exempt under Section 501(c)(6)), and "labor organizations" (exempt under Section 501(c)(5)). See 114 Cong. Rec. 7879 (1968).

At the hearings in 1969, Congress heard testimony from spokesmen for numerous Section 501(c)(6) groups (such as the American Medical Association, the American Dental Association, and the American Physical Therapy Association) and from numerous Section 501(c)(3) groups (such as the American Psychiatric Association, the American Osteopathic Association, and respondent). These spokesmen analyzed Example 7 in detail; at no point did they suggest that the taxability of advertising revenues from their medical journals would depend on the particular subsection of Section 501(c) under which they happened to be organized. Indeed, respondent's own witness testified that "[t]he new Treasury regulations have the effect of conclusively presuming that advertising income derived from the [C]ollege's publication constitutes taxable * * * income," and that the Regulation was "designed so as to preclude even the possibility that advertising which appears in the *Annals* can ever 'contribute importantly' to the [C]ollege's charitable function" (*House Hearings* 1113). Congress recited that the Regulation it aimed to codify had "mainly affected the advertising income of publications such as medical journals" (H.R. Rep. 91-413, *supra*, at 44) and stated that, under the statutory standard it was then adopting, "advertising in a journal published *by an exempt organization* is not related to the organization's exempt functions" (*id.* at 50 (emphasis added)). Congress drew no distinction on that score between different species of tax-exempt groups that publish advertising for profit.

Commentators discussing the effect of Congress's enactment in 1969 of Section 513(c) have concluded that "advertising income from a periodical *of an otherwise tax-exempt organization* is subject to the unrelated business income tax." Sugarman & Vogt, *supra*, 54 Taxes at 196 (emphasis added; footnote omitted). Neither court below accepted, or even mentioned, respondent's suggestion that tax-exempt publishers should receive differential tax treatment depending on the source of their exemption. And commentators who have considered respondent's argument since the decision below was issued agree that the attempted distinction is meritless. See Weinberg & Nixon, *What Are The Implications of the Federal Circuit's Holding in American College?* 62 J. Tax. 242, 243 (1985) ("[I]t may be that the court [of appeals] viewed Example 7 as inapplicable to a 501(c)(3) organization, but nothing in Example 7 suggests [that] such a restrictive application was intended by the Treasury.").

Respondent's argument, moreover, makes no sense as a construction of the Regulation. While it is true that there are some "differences in purposes" (Br. in Opp. 12) between Section 501(c)(3) groups and Section 501(c)(6) groups, those differences, in the case of professional associations like respondent, are usually slight (see pages 35-36, *supra*), and in any case are irrelevant in this context. The trade association described in Example 7 has among its exempt purposes the "continuing education of its members in matters pertaining to their profession," and the Example concludes that its publication of commercial advertising "is not an educational activity" (Treas. Reg. § 1.513-1(d)(4)(iv)(Example7)). Respondent also has among its exempt purposes the continuing education of its members in matters pertaining to their profession, and respondent publishes commercial advertising substantially identical to that described in the Example. It is the educational charac-

ter vel non of the *advertising* that determines whether the resulting revenues are subject to unrelated business income tax. It can scarcely be contended that the advertising described in Example 7 would become more "educational" simply by virtue of being published by an organization claiming exemption under Section 501(c)(3). Either the advertising is "educational" or it is not.

Respondent's suggested distinction, finally, makes nonsense of the policy of the unrelated business income tax. Congress enacted that tax, and amended it in 1969 specifically to bring advertising revenues within its scope, in order to prevent tax-exempt groups from obtaining an unfair advantage over their taxable competitors in the marketplace. On respondent's theory, revenues from a drug ad run in the journal of the American Medical Association, a Section 501(c)(6) group, would be subject to tax, while revenues from an identical drug ad run in its own journal would be exempt from tax, simply because it chose to be organized under Section 501(c)(3). The provenance of respondent's tax exemption, however, makes no difference to the taxpaying publishers with which it competes, and respondent's theory would perpetuate the unfair competition that Congress in 1969 aimed to stop. Indeed, respondent's theory would exacerbate the problem, for it would enable some tax-exempt publishers to compete unfairly, not only with taxpaying publishers, but with other tax-exempt publishers as well. And since a professional association like respondent can generally choose to be organized under either Section 501(c)(3) or Section 501(c)(6), respondent's theory in effect would make the payment of tax on advertising profits *elective*, a result that Congress would surely find rather surprising.

Accordingly, there is no merit to respondent's argument that the principles of Example 7 do not apply to it. It will not do for respondent to posit an erroneous distinction, suggest that the court of appeals, by its silence, "obviously agreed" with it (Br. in Opp. 13), and thereby excuse that court for ignoring a Regulation that Congress explicitly approved and that precisely describes the situation here.[13]

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[13] Contrary to respondent's contention (Br. in Opp. 5-6, 12, 14 n.20), Example 5 of the Regulation provides no support for its position. As noted above (pages 28-29 note 10, *supra*), that Example concerns advertising published in a student-run campus newspaper, where "solicitation, sale and publication of the advertising are conducted by students, under the supervision and instruction of the university" (Treas. Reg. § 1.513-1(d)(4)(iv)(Example 5)). The Example concludes that "the advertising business contributes importantly to the university's educational program through the training of the students involved" (*ibid.*). Noting that Example 5 involves a university, a Section 501(c)(3) organization, respondent regards it as standing for the general proposition that advertising published by Section 501(c)(3) groups, as contrasted with advertising published by Section 501(c)(6) groups, is substantially related to educational purposes. See Br. in Opp. 12, 14 n.20; C.A. Br. 30-31; Cl. Ct. Br. 22-25. This argument is frivolous. Example 4, the immediately preceding Example, also involves a Section 501(c)(3) group, one organized to advance "public interest in classical music," which owns a radio station; Example 4 concludes that the station's revenues "from the regular sale of advertising time and services to commercial advertisers in the manner of an ordinary commercial station" are taxable as unrelated business income. Treas. Reg. § 1.513-1(d)(4)(iv)(Example 4). Accord, Rev. Rul 76-93, 1976-1 C.B. 170 ("conventional" commercial advertising published by Section 501(c)(3) group is unrelated to its exempt purposes); Rev. Rul. 72-431, 1972-2 C.B. 281, 282 (same). In all these instances, it is the similarity vel non of the advertising to *commercial* advertising, not the subsection of Section 501(c) under which the publisher happens to be organized, that determines the taxability of the advertising profits. Respondent's theory would yield the absurd result that a Section 501(c)(3) group's *radio* advertising profits (Example 4) are taxable, while its *print* advertising profits (Example 7 supposedly being inapplicable) are not. Neither the IRS nor Congress can rationally be thought to have intended such an outcome.

E. Reversal Of The Decision Below Is Supported By Strong Considerations Of Tax Policy, Administrative Convenience, And Common Sense

The Federal Circuit has invalidated sub silentio longstanding Treasury Regulations that Congress considered in 1969 and upon which it placed its specific imprimatur. In so doing, the court has reopened the tax "loophole" (114 Cong. Rec. 27785 (1968)) that Congress, sixteen years ago, took no little trouble to close. The court of appeals' reasoning can be pressed into service by hundreds of tax-exempt professional and trade journals nationwide. Associations of chemists, engineers, geologists, and water pollution experts, no less than of doctors, can plausibly argue (as they argued to Congress in 1969) that their members' professional competence is enhanced by updated information contained in advertisements for new products and services. Indeed, the tax-exempt press has hailed the court of appeals' holding as "undoubtedly a landmark decision" that may enable "many non-profit associations * * * to establish that their journal advertising is substantially related to exempt purposes and not subject to taxation." 22 *Non-Profit Organization Tax Letter* No. 13, Oct. 5, 1984, at 3. As one witness put it during the 1969 congressional hearings, the subjective, ad-by-ad approach adopted by the court below "would be a wide open, tax-escaping door, and every advertisement would somehow be related." *House Hearings* 1150.

The decision below, however, has repercussions far beyond the tax revenue at stake. The unrelated business income tax has a significant regulatory function. Congress designed the tax, not just to raise money, but to keep the commercial endeavors of exempt and non-exempt competitors on a par. By permitting respondent to operate its commercial advertising business tax-free, while its business rivals must pay tax, the court of appeals has flouted this sharply-defined legislative policy.

The practical consequences of the court's open-ended reasoning, moreover, would entail formidable burdens on IRS audit resources. Under the heretofore unquestioned rule that "advertising designed and selected in the manner of ordinary commercial advertising" is subject to tax (Treas. Reg. § 1.513-1(d)(4)(iv)(Example 7)), IRS examiners were not required to investigate the "educational" function of advertisements on an ad-by-ad basis. The agent's task was simply to identify the advertising generally as being for *commercial* products or services. Under the decision below, by contrast, IRS agents would apparently have to figure out, on a case-by-case basis, which commercial advertisements "contribute importantly" to the publisher's exempt function and which do not.[14] As a witness testified before Congress in 1969, "[t]o draw the line on an individual basis * * * and to say that this is advertising which is unrelated and that [that is] advertising [which] is related would present to the IRS[,] and taxpayers generally, an almost insurmountable audit problem." *House Hearings* 1184 (American Society of Association Executives). The existing Treasury approach, by establishing that *commercial* advertising is unrelated per se to exempt purposes, produces logical tax consequences and prevents

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[14] The court of appeals, for example, highlighted an advertisement placed in *Annals* for *Medical Economics* (Pet. App. 60a), a magazine that "help[s] provide [doctors with] answers to such questions as whether 'the new Seville [is] worth its $12,479 base price' " (Pet. App. 32a n.7), and suggested that it would not qualify as "substantially related" to the College's educational function. See *id.* at 19a and n.23. But would the same be said about an ad placed by an interior decorating firm that specializes in doctors' offices? And does a drug ad serve an educational purpose when the product is widely known and has been available (say) for 15 years? The court of appeals' analysis is of such uncertain dimensions that it suggests no answers to questions like these.

journals from manipulating the tax outcome by advising their advertisers to insert incidental "educational" boilerplate in their ads. The court of appeals has discarded that analysis and has provided no workable standard to take its place.

The court of appeals' reasoning, finally, does no little violence to common sense. Everyone agrees that "[a]ll advertising is * * * educational or informational to some degree" (Pet. App. 29a). The reason sellers advertise is to communicate a message that they want buyers to hear. And everyone agrees that respondent engages in a proper—indeed, in a highly laudable—activity when it undertakes to keep doctors apprised of new medical developments. To the extent that respondent uses the articles and editorial content of its journal to accomplish that end, the income it realizes (*i.e.*, its subscription and dues income) is unquestionably exempt from tax. But to the extent that respondent uses commercial advertising as the information-conveying vehicle, charging the advertiser a fee as a condition of publishing the ad, the message is plainly that of the advertiser rather than one to which respondent would choose to devote its own, general resources. As Judge Kozinski suggested, respondent in a sense had two options: to "include advertising for its members free of charge" or to "sell advertising as a business * * * and make a profit on it" (J.A. 49a). In choosing the latter option over the former, obviously, respondent was motivated entirely by revenue-raising, and not at all by educational, concerns. Respondent's educational objectives were *of necessity* inconsequential in its decision to publish *commercial* advertising. Congress accordingly determined, as we have shown, that respondent should pay tax on its commercial advertising profits just as any other publisher would have to do.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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